

**STATE OF ALABAMA**  
**DEPARTMENT OF INSURANCE**  
**MONTGOMERY, ALABAMA**

**REPORT ON EXAMINATION**

**As of**

**DECEMBER 31, 2003**

**Of the**

**QUALITY CASUALTY INSURANCE COMPANY**

**ALEXANDER CITY, ALABAMA**

**PARTICIPATION:**

**ALABAMA**

**EXAMINATION AFFIDAVIT**

*STATE OF ALABAMA*

**COUNTY OF MONTGOMERY**

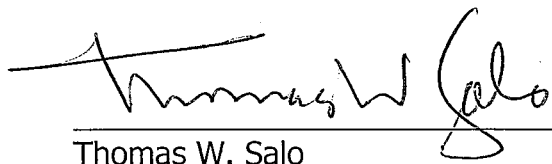
Thomas W. Salo being first duly sworn, upon his oath deposes and says:

That he is an examiner appointed by the Commissioner of Insurance for the State of Alabama;


That an examination was made of the affairs and financial condition of Quality Casualty Insurance Company for the period of January 1, 2001 through December 31, 2003;

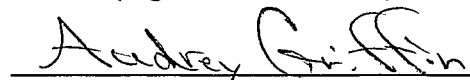
That the following 32 pages constitute the report thereon to the Commissioner of Insurance of the State of Alabama;

And, that the statements, exhibits, and data therein contained are true and correct to the best of his knowledge and belief.

  
\_\_\_\_\_  
Thomas W. Salo  
Examiner-in-charge

Subscribed and sworn to before the undersigned authority this May 16, 2005,

  
\_\_\_\_\_  
(Signature of Notary Public)

  
\_\_\_\_\_  
Printed name Notary Public

in and for the State of Alabama

My commission expires 11/2/05

## TABLE OF CONTENTS

Salutation .....	1
Scope of Examination .....	2
Organization and History .....	3
Growth of the Company .....	4
Statutory Deposits .....	4
Holding Company and Affiliate Matters .....	4
Holding Company Registration and Reporting .....	5
Organizational Chart .....	5
Agreements with Affiliates .....	7
Management and Control .....	7
Stockholder .....	7
Board of Directors .....	7
Officers .....	8
Conflict of Interest .....	8
Management and Service Agreements .....	9
Corporate Records .....	11
Territory .....	12
Fidelity Bond and Other Insurance .....	12
Employee and Agents' Welfare .....	12
Market Conduct .....	12
Plan of Operation .....	12
Policy Forms and Underwriting .....	12
Compliance with Agents' Licensing Requirements .....	13
Dividends to Stockholder .....	13
Advertising .....	13
Claims Payments Practices .....	13
Privacy Policy and Practices .....	13
Fraud Policy .....	14
Reinsurance .....	14
Reinsurance Assumed .....	14
Reinsurance Ceded .....	14
Accounts and Records .....	15
Internal records .....	15
External Audits .....	16
Financial Statements .....	17
Statement of Assets, Liabilities, Surplus and Other Funds .....	18
Comparative Summary of Operations .....	19
Reconciliation of Capital and Surplus .....	20

## **TABLE OF CONTENTS-CONTINUED**

Notes to the Financial Statements .....	21
Note 1 – Bonds .....	21
Note 2 – Cash and Short-term Investments.....	21
Note 3 – Losses and Loss Adjustment Expense.....	23
Note 4 – Dividends Paid .....	23
Note 5 – Gross Paid-In and Contributed Surplus .....	24
Note 6 – Unassigned Funds.....	24
Contingent Liabilities and Pending Litigation .....	24
Comments and Recommendations .....	25
Subsequent Events .....	29
Conclusion.....	32



Bob Riley  
GOVERNOR

STATE OF ALABAMA  
DEPARTMENT OF INSURANCE  
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CHIEF EXAMINER  
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STATE FIRE MARSHALL  
JOHN S. ROBISON

GENERAL COUNSEL  
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Alexander City, Alabama  
May 16, 2005

Honorable Walter A. Bell  
Commissioner of Insurance  
State of Alabama  
P.O. Box 303350  
Montgomery, Alabama 36130-3350

Dear Commissioner Bell:

Pursuant to your instructions and in compliance with the statutory requirements of the State of Alabama and the resolutions adopted by the National Association of Insurance Commissioners, an examination has been made of the affairs and financial condition of the:

**Quality Casualty Insurance Company**  
**Alexander City, Alabama**

at its home office located at 1244 Cherokee Road, Alexander City, Alabama 35010, as of December 31, 2003. The report of examination is submitted herewith.

Where the description "Company" appears herein without qualification, it will be understood to indicate Quality Casualty Insurance Company.

## **SCOPE OF EXAMINATION**

The examination reported herein covers the period from January 1, 2001, through December 31, 2003, and has been conducted by examiners representing the State of Alabama Department of Insurance. Events subsequent to December 31, 2003, have been reviewed, and are reported herein, as deemed appropriate.

The examination has been conducted in accordance with statutory requirements of the *Alabama Insurance Code* and regulations and bulletins of the Alabama Department of Insurance; in accordance with the applicable guidelines and procedures of the National Association of Insurance Commissioners (NAIC); and in accordance with generally accepted examination standards.

The examination included a general review of the Company's operations, administrative practices, and compliance with statutes and regulations. Corporate records were inspected. Income and disbursement items for selected periods were tested. Assets were verified and valued, and all known liabilities were determined or estimated as of December 31, 2003, as shown in the financial statements contained herein.

In compliance with requirements of the Alabama Department of Insurance, a signed certificate of representation was obtained from the President and the Chief Financial Officer of the Company. In this certificate, management attests to having valid title to all assets and to the non-existence of unrecorded liabilities as of December 31, 2003. A signed letter of representation was also obtained at the conclusion of the examination whereby the President and Chief Financial Officer represented that, through the date of this examination report, complete disclosure was made to the examiners regarding asset and liability valuation, financial position of the Company, and contingent liabilities.

Within this report, discussions of financial statement balances have been confined to those items for which a material change in the financial statement has been noted or for which comments and /or recommendations have been made.

A market conduct examination was performed concurrently with the financial examination. The market conduct examination included a review of the Company's operations/management; complaint handling; marketing and sales; producer licensing; policyholder service; policy forms, rating and underwriting practices; privacy issues; and claims. See page 12 for further discussion of the market conduct examination. Certain required elements relating to these areas of examination will be included in this report. However, where no exceptions were noted in particular areas, details of the various tests conducted are not included in this report. If exceptions were identified as part of this examination,

the details of the exceptions, the related tests, and recommendations are included in the appropriate sections of this Report of Examination.

### **ORGANIZATION AND HISTORY**

Quality Casualty Insurance Company, Inc. (QCIC or "Company") was founded as a Casualty only (Power 3) insurer on February 28, 2001 and technically commenced operations the same day. However, no premium was added to the Company's books until January 2002. The Company writes only non-standard auto. During the first six months of 2002 the Company underwent a growth campaign fueled almost exclusively by a massive roll over of business that was being non-renewed by Continental National Indemnity Company (CNIC). During the latter half of 2002 the Company added business to their books through direct writing - which like the rest of their business was reinsured in an 80/20 Quota Share deal. The President of CNIC was Mr. Bryan Woods. He came over to QCIC as CFO immediately after leaving CNIC. He maintained his business relationship with QCIC President, Mr. I. Jess Chappell, who owned the MGA that handled this book of business while it was under CNIC. During the time the roll over business was being added QCIC employed three reinsurers (QBE Reinsurance, National Grange Reinsurance Corp and Continental Casualty Company) which combined to assume 80% of the Company's business. As this phase of business ended, QCIC altered their reinsurance line up by going with a single company - Lincoln General Insurance Company. The terms of the reinsurance treaty were modified to allow QCIC the ability to keep the fees associated with the handling of the book (i.e., MVR fees and installment charges.) In exchange, the reinsurer only had to pay 24.5% in ceding commissions - as opposed to the 28% that was in place when the coverage was handled by the three reinsurers. As of year end 2002, the Company had nearly 1.5M in surplus, with nearly 1.3M coming in the form of payments from Chappell Insurance Services, QCIC's parent. The Company began operations with \$500,000 in capital stock, which has not undergone any changes since inception of business. QCIC operates only in Alabama, although corporate headquarters are in Savannah, GA and claims are handled at Cange and Woods' office in Cincinnati, OH.

## **FINANCIAL GROWTH OF THE COMPANY**

The following schedule presents financial data, which reflects the growth of the Company for the years indicated:

<b><u>Year</u></b>	<b><u>Net Written Premiums</u></b>	<b><u>Admitted Assets</u></b>	<b><u>Liabilities</u></b>	<b><u>Capital and Surplus</u></b>
2001	\$ -0-	\$1,538,613	\$4,070	\$1,534,543
2002	\$3,621,984	\$7,131,812	\$5,645,687	\$1,486,125
2003	\$2,831,879	\$6,326,062	\$5,164,882	\$1,161,180

Data for the years 2001 and 2002 are per the Company's annual statements. Data for 2003 are per examination.

## **STATUTORY DEPOSITS**

In accordance with applicable Alabama insurance statutes, the Company maintained the following deposit with the Alabama Department of Insurance, at December 31, 2003:

U.S. Treasury Note, dated January 31, 2002, 3.0%, maturing January 31, 2004, book value and statement value of \$504,739.

Confirmation of this deposit was obtained directly from the Alabama Department of Insurance.

## **HOLDING COMPANY AND AFFILIATE MATTERS**

### **Holding Company Registration and Reporting**

The Company was subject to the Alabama Insurance Holding Company Regulatory Act of 1973, as defined in ALA. §CODE §27-29-1 (1975).

The Company is responsible for holding company registration statement (Form B) and periodic informational filings with the Alabama Department of Insurance, in accordance with ALA. CODE §27-29-4 (1975), and the ALA. ADMIN. CODE 482-1-55 (2002).

In connection therewith, the Company was registered with the Alabama Department of Insurance as the registrant of an Insurance Holding Company System. A review of the Company's Form B Amendments filed for the period



under examination indicated that all required filings had been made in a timely manner.

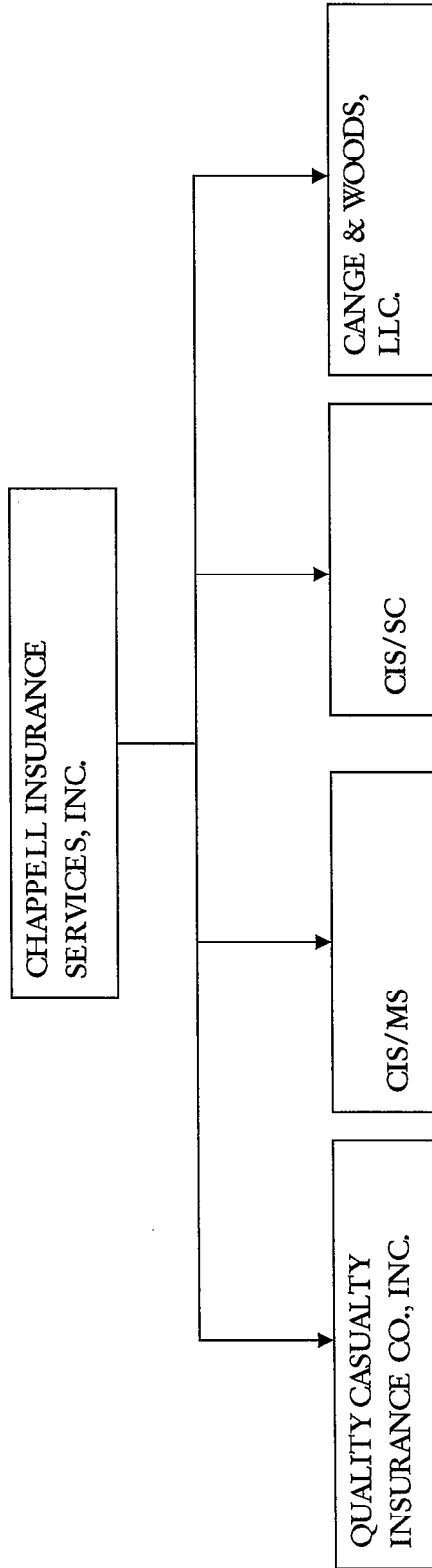
The Company did not include Schedule Y, Part 2 as part of the annual statement, in accordance with NAIC Annual Statement Instructions in that they did not include the transactions between affiliates or related parties.

### **Organizational Chart**

The chart on the following page depicts the insurance holding company system with which the Company was affiliated as of December 31, 2003.

(see next page for organizational chart)

## Organizational Chart



### **Agreements with Affiliates**

See "Management and Service Agreements," page 9.

## **MANAGEMENT AND CONTROL**

### **Stockholder**

Since the Company's inception, Chappell Insurance Services, Inc. (CIS) has been the sole stockholder.

### **Board of Directors**

The number of Directors constituting the Board of Directors shall be fixed by the shareholders at their annual meeting, or at any special meeting called for that purpose, and such number so fixed shall continue to be the number of Directors until changed by the shareholders. The Board of Directors shall be elected annually by the shareholders at their annual meeting, or at a special meeting, and shall hold office at the pleasure of the shareholders until respective shareholders are elected. Directors need not be residents of the state of Alabama or shareholders of the Corporation.

The following persons were serving as directors of the Company at December 31, 2003:

<u>Director</u>	<u>Principal Occupation</u>
I. Jess Chappell	Chairman of the Board, Chief Executive Officer and President of the Company
Frank L. Chappell	Executive Vice President of the Company
Christine T. Cromer	President, First Insurance

During the examination it was noted that the Company did not elect their board members as prescribed in its By-Laws. Thus, the Company was not in compliance with its Bylaws with regard to holding an annual shareholders' meeting with the purpose of electing Directors for the period of examination. The Company should take appropriate actions to comply with its Bylaws with regard to the annual election of Directors.

## **Officers**

The Company's By-Laws provide that its officers shall include the President and a Secretary, both of whom shall be appointed by the Board of Directors. One or more Vice Presidents, a Treasurer, and such other officers and assistant officers as may be deemed necessary may be appointed by the Board of Directors. Any number of offices may be held by the same person. The officers of the Corporation shall be appointed annually by the Board of Directors at the regular meeting of the Board.

The following persons were serving as officers of the Company at December 31, 2003:

<u>Officer</u>	<u>Title</u>
I. Jess Chappell	President
Frank L. Chappell	Secretary
Frank L. Chappell	Treasurer

During the examination, it was noted that the Company did not elect their officers as prescribed in its By-Laws. Thus, the Company was not in compliance with its Bylaws with regard to holding an annual shareholders' meeting with the purpose of electing Officers. The Company should take appropriate actions to comply with its Bylaws with regard to the annual election of Officers.

## **Conflict of Interest**

The Company's conflict of interest policy requires that no director, officer or other employee shall permit private interests to conflict with the proper discharge of duties, or use the position held or the knowledge gained therein in such manner as to give the appearance of such conflict.

In a response to a request for conflict of interest statements applicable to the examination period, the examiner was provided with statements executed by the directors and elected officers of the Company.

However, during the examination it was found that numerous payments were made by the Company to pay bank notes that were in the names of officers/shareholders of the Company's parent, Chappell Insurance Services, Inc. This is a pecuniary interest violation as described in ALA. CODE §27-27-26(1975).

This is a pecuniary interest violation as described in ALA. CODE §27-27-26(1975).

Also, the Company was found to have issued a check for \$420.61 to one of its officers which represented a payroll advance. This is a pecuniary interest violation of ALA. §27-27-26 which states that "Any officer ... of a domestic insurer...shall not borrow the funds of such insurer." A loan such as this to an officer is also a violation of ALA. CODE §27-41-36 (a)(1975) which states that "an insurer shall not invest in or lend its funds upon the security of any note or other evidence of indebtedness of any director, officer or controlling stockholder of the insurer... " Further, ALA. CODE §27-37-2 (2) states "(2) Advances to officers, directors and controlling stockholders, other than policy loans, unless the same are secured by collateral satisfactory to the commissioner, and advances to employees, agents and other persons on personal security only;..." shall be non-admitted as assets of the Company. The amount of the advance to the Company officer was immaterial and no adjustment will be made to the annual statement.

### **Management and Service Agreements**

The Company does business with its affiliates via management and service agreements amongst the parties involved. The NAIC Annual Statement Instructions require that these management and service contracts be reported on Schedule Y- Part 2 of the Annual Statement.

The following agreements were in effect during the examination period and at December 31, 2003:

#### **Cost sharing agreement**

This agreement was effective January 1, 2003 and will remain in effect until terminated by either party providing thirty days notice to the other.

The agreement stipulates that Quality Casualty Insurance Company (QCIC) is to provide certain policy issuance, billing, collection and administrative functions for Chappell Insurance Services (CIS) and seeks to be fairly compensated for services provided. Services to be provided include:

- Acceptance and processing of insurance applications
- Policy issuance
- Billing and collections
- Policy administration

To compensate QCIC for rendering these services to CIS, expenses incurred by QCIC (and recorded in the general ledger accounts listed below) are to be

allocated on a monthly basis. Apportionment is to be based on the proportion of cumulative annual direct written premium by CIS to the total of cumulative annual direct written premium for QCIC and CIS. Expenses subject to this allocation are captured in the following QCIC general ledger accounts:

- Salaries and wages
- Payroll taxes on the above
- Employee relations and welfare
- Insurance
- Travel and travel items
- Printing and stationery
- Postage, telephone, and exchange

This agreement was in effect during the examination. However, it was noted that it was not approved by ALDOI in accordance with ALA. CODE §27-29-5 (b) (4) (1975). A revised cost-sharing agreement was submitted to ALDOI during the examination, and was approved by the Commissioner on October 26, 2004.

During the examination, it was noted that the Company is not only doing business with Chappell Insurance Services (its Parent) but also with two other affiliates--CIS/MS and CIS/SC. As mentioned above, the Company has in place an approved cost-sharing agreement between Quality Casualty Insurance Company and Chappell Insurance Services. However, no other company is mentioned in this agreement. ALA. CODE 27-29-5 (b) (4) (1975) states that all management agreements, service contracts and cost-sharing arrangements shall be approved by the Commissioner.

Further, as stated, the examination found that the Company was also doing business with its affiliate, CIS/SC. However, the Company did not list CIS/SC on its registration statement filed for 2003. ALA. CODE 27-29-4 states that the Company is required to identify every member of the insurance holding company system in its registration statements.

#### Claim administrator agreement

This agreement was effective September 1, 2001 and shall remain in full force and effect until terminated. Either party may terminate the agreement by sending not less than ninety days prior written notice to the other, by certified mail to the other party's principal place of business, stating the effective date of termination.

The agreement states that Quality Casualty Insurance Company (QCIC) is to employ Cange and Woods (C & W) to perform claims adjustment and administrative services for certain claims and losses arising out of policies issued

by QCIC. In return for the claims and adjusting service, QCIC will pay C & W a service fee in the amount of 3.5% of earned premium relating to QCIC as developed on the premium reports provided to C & W. On October 1, 2002, an amendment was made to the agreement which states that in the event the total amount paid to C & W by QCIC, based on QCIC's 2002 Earned Premium, exceeds \$400,000, the amount paid in excess of \$400,000 will be returned to QCIC on or before March 31, 2003. In addition, C & W will receive 20% of salvage and subrogation collected on behalf of QCIC.

Even though this agreement was in effect during the examination, it was found that the Company was operating under this claim administrator agreement which had not been approved by ALDOI in accordance with ALA. CODE §27-29-5 (b) (4) (1975).

#### Administrative office lease agreement

The effective date of this lease agreement between Chappell Insurance Services, Inc. and Quality Casualty Insurance Services (the tenants), and 24 Drayton Street, LLC, (the landlord) is October 2, 2003.

The lease agreement stipulates that the landlord leases office space designated as Suite 200, containing 5,103 square feet, at 24 Drayton Street for \$6,591.00 per month.

The Company and its parent, Chappell Insurance Services, Inc., were operating under this lease agreement during the period of the examination. However, this lease agreement had not been approved by ALDOI in accordance with ALA. CODE §27-29-5 (b) (4) (1975).

#### **CORPORATE RECORDS**

The Articles of Incorporation and By-Laws were reviewed and found to provide for operation of the Company in accordance with Alabama statutes and regulations and accepted corporate practices.

Minutes of the meetings of the Board of Directors and Stockholder from March 1, 2001 through the most recent meetings recorded were reviewed. The minutes appeared to be complete and to adequately document the actions of the governing bodies.

## **TERRITORY**

Since the Company's inception, its territory has been limited to the State of Alabama. At December 12, 2001, the Company was licensed by the Alabama Department of Insurance to write miscellaneous casualty insurance.

## **FIDELITY BOND AND OTHER INSURANCE**

At December 31, 2003, the Company's fidelity bond coverage was included in a crime insurance policy issued through The F & D Companies. The Company had liability coverage for employee theft. At December 31, 2003, the Company had coverage in excess of the NAIC's suggested minimum amount of fidelity insurance.

In addition to the aforementioned fidelity bond, the following policies or coverages were maintained by or on behalf of the Company at December 31, 2003:

- 1 General liability
- 2 Workers Compensation and Employer's Liability Policy

## **EMPLOYEE AND AGENT'S WELFARE**

At December 31, 2003, the Company had twenty-three employees and they had no retirement plan, deferred compensation plan and/or benefit plan in effect.

## **MARKET CONDUCT**

### **Plan of Operation**

The Company markets only non-standard automobile insurance throughout Alabama via a force of independent agents.

### **Policy Forms and Underwriting**

At December 31, 2003, the Company wrote only non-standard automobile insurance. The policy forms for this insurance were approved by the Alabama Department of Insurance on December 21, 2001 and effective on January 1, 2002.



### **Compliance With Agent's Licensing Requirements**

A review of Company records was made by the examiner to determine that agents representing the Company in Alabama were appropriately licensed. A sample of commission payments was reviewed. No exceptions were noted with the agents' licensing requirements of the State of Alabama.

### **Dividends to Stockholder**

Since the inception of the Company, no dividends have been paid to the shareholder. However, during the examination, the examiners reclassified \$34,902 which represents payments made during the examination by the Company on bank loans that belonged to officers/stockholders of the Company's parent, Chappell Insurance Services, Inc.

The Company needs to comply with the standards as set forth in ALA. CODE §27-29-5(1975).

### **Advertising**

The Company did not have a formal advertising program.

### **Claims Payment Practices**

A sample of claims was reviewed in order to evaluate the Company's claims payment practices. Claims were reviewed with regard to compliance with policy provisions, timeliness of payment and adequacy of documentation. No noteworthy discrepancies were found within the sample.

The Alabama Department of Insurance, Consumer Division, reported no complaints against the Company in 2003.

### **Privacy Policy and Practices**

The examiners reviewed the Company's privacy procedures and found the following:

1. The Company does not have a formal training manual. However, the Company does instruct its employees as to the normal procedures for day-to-day handling of nonpublic personal information. The information is distributed in the normal course of the Company's business to internal and affiliated persons only.
2. The Company's claims administrator, Cange & Woods, LLC, has a Claims Manual which addresses privacy standards.

3. The Company writes six month policies; it provides Privacy Notices with the initial policy, on renewals and on endorsements.

4. The Company does not disclose any nonpublic information on its policyholders unless required by law. This includes personal health or financial information. For this reason, the Company does not need to provide opt-out statements to its policyholders.

Overall, the examiner determined that the Company was following the privacy procedures and standards contained in ALA.ADMIN. CODE 482-1-122(2001).

### **Fraud Policy**

The Company does not have a formalized anti-fraud program in force for underwriting. However, the Company's TPA and Claims Administrator, Cange & Woods, LLC, has a written program entitled "Anti-Fraud Plan" which is distributed to all of its employees. This program sets forth detailed policies and procedures that are to be followed if fraud becomes an issue in relation to a claim. Along with this, a comprehensive listing entitled "Bodily Injury Indicators of Possible Fraud" is also given to employees. If actions by a claimant result in a positive response to any of the indicators on this listing, the claim is remitted to the Special Investigation Division of Cange & Woods, LLC for the investigation of possible fraudulent activity. Suspected fraud is promptly reported to the appropriate insurance and/or police authority.

## **REINSURANCE**

### **Reinsurance assumed**

During the examination period, the Company has assumed no reinsurance.

### **Reinsurance ceded**

Since its inception, all personal auto business written in Alabama by the Company has been ceded pursuant to an 80% pro rata reinsurance agreement. All reinsurance contracts have been placed through its reinsurance broker - Guy Carpenter. The initial quota share contract was effective July 1, 2001 and was in effect until June 30, 2002. (Note that although the treaty was effective July 1, 2001, the Company wrote no policies and no premium was ceded to this contract until January of 2002.)

The 80% ceded participation on the initial contract was 52.5% CNARE, 15% QBE, and 12.5% Grange. Eighty percent of premiums written and installment fees collected were the subject premium of the contract. Losses and loss

adjustment expenses incurred were also ceded to the contract. The Company was also given a ceding commission of 28.5% of the subject premium for policies written between January 1, 2002 and June 30, 2002. Losses (net of salvage and subrogation) and loss adjustment expenses incurred are ceded to each participant in proportion to their participation. Thirty days after each month end a settlement statement is prepared based on:

Collected Premium and installment fees  
Less 28.5% of written premium  
Less paid losses, net of collected salvage and subrogation  
Less paid loss adjustment expenses.

Positive balance was remitted to the broker to be proportionately distributed to the reinsurers. Negative balances were collected by the broker and remitted to the Company.

The maximum retained liability by the Company was 20% of the maximum policy limits that could be ceded to the reinsurer. The maximum per policy limits per the reinsurance contract were:

BI \$100,000 per person / \$300,000 per occurrence  
PD \$100,000 per occurrence  
Comp/Collision ACV up to \$50,000 per vehicle  
UIM \$20,000 per person / \$40,000 per occurrence  
UIM PD \$10,000 per occurrence

Therefore, the maximum reinsurance provided under this contract is 80% of the above coverage limits.

Effective July 1, 2002, the reinsurance contract described above was replaced with a substantially identical contract with Lincoln General Insurance Company as the sole 80% quota share reinsurer. This contract remains in effect to date. Differences from the points raised above are:

- Subject premium does not include installment fees
- Ceding commission is 24%
- Monthly settlement statements (excluding installment fees) are prepared on the 20<sup>th</sup> of the following month

## **ACCOUNTS AND RECORDS**

### **Internal Records**

The Company's accounts and records are maintained primarily by Chappell Insurance Services (CIS), Savannah, Georgia, in accordance with a Cost-Sharing agreement, previously discussed in "Management and Control," subsection, "Management and Services Agreement." The majority of the Company's claim records relating to its insurance business are generated by its third party administrator, Cange and Woods, LLC (C & W), located in Cincinnati, Ohio, but the aforementioned agreement provides that CIS is responsible for booking these transactions. Virtually all the records were computer generated, except for checks and application files. The Company is able to access most of their records electronically through a computer network.

Application files, claims files in process, and the claims register were not maintained in the Company's home office. After claims have been paid, the claim files are retained an additional six months at C & W to facilitate any subsequent claim requests. After six months expire, the paid claim files are sent to the Company's home office in Alexander City, Alabama for storage. The application files and files relating to premium information are maintained at CIS in Savannah, Georgia. Selected samples of these files were requested and transferred from C & W in Cincinnati, Ohio and CIS in Savannah, Georgia to the Company's home office in Alexander City, Alabama so they could be examined and reviewed. ALA. CODE § 27-27-29(a) (1975), requires that insurers maintain complete records within the state of Alabama. Also, it is a violation of ALA CODE § 27-27-29(c) (1975), to remove these records from the state of Alabama without the prior written permission of the Commissioner of the Alabama Department of Insurance.

Also see "Management and Service Agreements," page 8, for further discussion of the relationship between the Company, its parent, CIS, and the Company's third party administrator, C & W.

### **External Audits and Actuarial**

The Company is audited annually by the certified public accounting firm of Hullett, Kellum & McKinney, Birmingham, Alabama. The examiner obtained the audit reports for the years under examination, and discussed the Company's audits with the partner in charge of the audit work. It was deemed that reliance upon the external audit work would not be cost efficient for examination purposes, due to the small size of the Company and the anticipated short span of the examination.

The Company's reserves were certified and its Actuarial Opinions were rendered, for the years under examination, by Merlinos & Associates, Inc., located in Norcross, Georgia.

### **FINANCIAL STATEMENTS**

Financial statements included in this report, which reflect the operations of the Company for the years under examination and its financial condition at December 31, 2003, consist of the following:

	<u>Page</u>
Statement of Assets, Liabilities, Surplus, and Other Funds . . . . .	18
Comparative Summary of Operations . . . . .	19
Reconciliation of Capital and Surplus . . . . .	20

THE NOTES IMMEDIATELY FOLLOWING THE FINANCIAL STATEMENTS ARE AN  
INTEGRAL PART THEREOF.

# **STATEMENT OF ASSETS, LIABILITIES, SURPLUS AND OTHER FUNDS**

**For the Year Ended December 31, 2003**

## **ASSETS**

	<b><u>Ledger Assets</u></b>	<b><u>Non-Admitted Assets</u></b>	<b><u>Admitted Assets</u></b>
Bonds <b>(NOTE 1)</b>	\$ 1,267,093		1,267,093
Cash <b>(NOTE 2)</b>	1,785,627		1,785,627
Investment income due and accrued	15,596		15,596
Uncollected premiums & agent balances	914,542	164,296	750,246
Deferred premiums	1,778,706		1,778,706
Amts. recoverable from reinsurers	580,743		580,743
Current income tax recoverable	5,499		5,499
Net deferred tax asset	83,925	83,925	-
EDP equipment and software	61,474	42,000	19,474
Aggregate write-in for other than invested assets	5,268	5,268	-
Receivable from parent	187,392	64,314	123,078
Total Assets	<u>\$ 6,685,865</u>	<u>\$ 359,803</u>	<u>\$ 6,326,062</u>

## **LIABILITIES SURPLUS AND OTHER FUNDS**

### **Liabilities**

Losses <b>(NOTE 3)</b>	\$ 1,016,875
Loss adjustment expense <b>(NOTE 3)</b>	\$ 189,478
Commissions payable	\$ 192,152
Other expenses	\$ 46,100
Taxes, licenses and fees	\$ (31,212)
Unearned premiums	\$ 662,794
Ceded reinsurance premium payable	<u>3,088,695</u>
Total Liabilities	\$ 5,164,882

### **Surplus and Other Funds**

Common capital stock	\$ 500,000
Gross paid in and contributed surplus <b>(NOTE 5)</b>	1,201,686
Unassigned funds <b>(NOTE 6)</b>	<u>(540,506)</u>
Total capital and surplus	<u>1,161,180</u>
Total Liabilities, Surplus and Other Funds	<u>\$ 6,326,062</u>

# COMPARATIVE SUMMARY OF OPERATIONS

For the Years Ended December 31,

	<u>2003</u>	<u>2002</u>	<u>2001</u>
<b><u>Income:</u></b>			
Premium considerations	\$ 2,980,863	\$ 2,810,206	
Net investment income	24,457	31,095	30,429
Write-in for miscellaneous income		82,905	
Total income	<u>\$ 3,005,320</u>	<u>\$ 2,924,206</u>	<u>\$ 30,429</u>
<b><u>Deductions:</u></b>			
Losses incurred	\$ 1,912,648	\$ 1,767,291	
Loss expenses incurred	\$ 178,243	\$ 131,378	
Other underwriting expenses ( <b>NOTE 4</b> )	1,012,735	1,245,785	3,294
Total deductions	3,103,626	\$ 3,144,454	\$ 3,294
Federal income taxes incurred	(5,554)	4,105	4,070
<b>Net Income (Loss)</b>	<u>\$ (92,752)</u>	<u>\$ (224,353)</u>	<u>\$ 23,065</u>

# **RECONCILIATION OF CAPITAL AND SURPLUS**

	For the years ended December 31,		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
Capital and surplus, January 1,	\$ 1,486,125	\$ 1,534,543	
Net income	\$ (92,752)	\$ (224,353)	\$ 23,065
Change in net income			
Decrease in loss reserves (NOTE 3)	\$ (182,000)		
Increase in loss adjustment expenses (NOTE 3)	\$ 182,000		
	(197,039)	(321,645)	(4,522)
Paid in capital			500,000
Paid in surplus		250,000	1,016,000
Dividends to stockholders (NOTE 4)	(34,902)		
Change in net deferred income tax	(252)	247,580	
Change in capital and surplus during year	\$ (324,945)	\$ (48,418)	\$ 1,534,543
Capital and surplus, December 31,	\$ 1,161,180	\$ 1,486,125	\$ 1,534,543



## **NOTES TO THE FINANCIAL STATEMENTS**

### **Note 1 - Bonds**

**\$1,267,093**

The amount of the captioned asset is the same as reported in the Company's 2003 Annual Statement and is comprised totally of U.S Treasury securities. The Company could not provide supportive documentation of the purchases and sales of its securities which transpired during the examination period.

In the review of the Company's custodial agreement with SunTrust Bank, it was noted that the agreement was not in compliance with ALA. ADMIN. CODE 482-1-077.04 (02) (O) (2003) which states that "The custody agreement is of no force and effect until the Commissioner approves, in writing, the custody agreement." The custody agreement with SunTrust had not been approved by the Commissioner of Insurance.

### **Note 2 - Cash**

**\$532,503**

#### **Short-term Investments**

**\$1,253,124**

The amounts of the captioned assets are the same as reported in the Company's 2003 Annual Statement. The Company reported two short-term investments totalling \$1,253,124 in Schedule E-Part 1-Cash of the 2003 Annual Statement. During the review of the deposits with Compass Bank at December 31, 2003, it was noted that the Company was reporting an Expedition Treasury II Money Market Fund in the amount of \$726,189 as cash, in Schedule E-Part 1-Cash and during the review of the deposits with SunTrust Bank at December 31, 2003, it was noted that the Company was reporting a STI Classic Money Market fund in the amount of \$526,935 as cash, in Schedule E-Part-1-Cash. The reporting of these two particular money market funds as cash is not in compliance with the instructions contained within the Purposes and Procedures Manual of the NAIC Securities Valuation Offices. These two funds are on the list of money market funds filed with the SVO U.S. Direct Obligations/Full Faith and Credit Exempt List. Both of these securities should have been reported in Schedule DA-Part 1 as short-term investments. These have been reclassified in accordance with the aforementioned SVO instructions.

During the review of the Company's repurchase agreement with SunTrust Bank, it was noted that the agreement was not appropriately collateralized in accordance with the NAIC Accounting Practices and Procedures Manual- SSAP 45, paragraph 8 a., which requires the following:

"The reporting entity shall receive as collateral transferred securities having a fair value at least equal to 102 percent of the purchase price paid by the reporting entity for the securities. If at anytime the fair value of the

collateral is less than 100 percent of the purchase price paid by the reporting entity, the counterparty shall be obligated to provide additional collateral, the fair value of which, together with fair value of all collateral then held in connection with the transaction, at least equals 102 percent of the purchase price."

The NAIC Annual Statement Instructions require in the Notes to Financial Statements section of the annual statement that the Company "disclose the policy for requiring collateral or other security as required in SSAP No. 45..." The Company did not comply with this disclosure.

The repurchase agreement should be accounted for as a collateralized lending and not as an actual purchase of the collateral that secures the transaction, in accordance with the NAIC Accounting Practices and Procedures Manual- SSAP 45 and Alabama Department of Insurance Regulation No. 97 Section 4, which adopted the NAIC Accounting Practices and Procedures Manual.

The Company reported the amount paid for the security at December 31, 2003 in Schedule E- Part 1 as cash instead of in Schedule DA- Part 1 as a short-term investment, which was not in compliance with the NAIC Accounting Practices and Procedures Manual. This misclassification however did not affect the Company's surplus.

During the review of the cash accounts in Schedule E of the 2003 Annual Statement it was noted that the Company was reporting the aggregate total of the account relationships with the various banks. The NAIC Annual Statement Instructions states "Report separately all deposits in excess of \$100,000 or less than (\$100,000)."

During the review of cash accounts, a funds transfer for \$76,278 on December 10, 2003 was made to one of the Company's checking accounts and on December 22, 2003 a funds transfer for \$6,587 was made from one of the Company's checking accounts. The Company provided bank statements whereby these transactions were effected, but they could not provide vouchers supporting the initiation of these transactions. Check #2306 dated July 1, 2003 was issued the amount in the amount of \$7,500 to Softech. The Company could not provide a supporting voucher for this check. The fact that the Company could not provide the supporting voucher for this transaction is a violation of ALA. CODE 27-27-30 (1975) which states that "No insurer shall make any disbursement of \$25.00 or more unless evidenced by a voucher or other document correctly describing the consideration for the payment and support by a check or receipt endorsed or signed by, or on behalf of, the person receiving the money.

**Note 3- Losses**  
**Loss Adjustment Expense**

**\$(180,380)**  
**\$180,380**

During the examination it was found that the Company's total Loss and LAE reserves are not categorized in accordance with SSAP 55, paragraph 5. All DCC reserves and most of the A & O reserves were booked as bulk and IBNR loss reserves. Therefore, loss reserves are overstated by \$180,380 and LAE reserves are understated by \$180,380. These have been reclassified in accordance with SSAP 55, paragraph 5.

**Note 4- Dividends paid**

**\$34,902**

The amount of \$34,902 is considered a dividend and represents payments made during the examination by the Company on bank loans that belonged to officers/stockholders of the Company's parent, Chappell Insurance Services, Inc.

During the examination, it was noted that the Company paid bank payments totalling \$34,902 that were in the names of the President, Executive Vice President and Senior Vice President of the Company. The Company stated that the payments on loans for the officers were for "car allowances." These loans to the officers were in the individual names of the officers personally---the Company name was not included on the loan documents. It was found that the Company did not report this as additional income to these officers on the Supplemental Compensation Exhibit and the income related to these car allowances was not reported to the Internal Revenue Service.

The payment of these bank payments by the Company for the loans that were in the names of the Company's officers is a pecuniary violation as set forth in ALA. CODE 27-27-26 (1975) which states "Any officer, or director... of a domestic insurer...shall not borrow the funds of such insurer."

Also, Chappell Insurance Services (CIS) is the sole stockholder of the Company and the officers, as mentioned above, represent the majority of the stockholders of CIS. ALA. CODE 27-27-37 (a) (1975) states "a domestic stock insurer shall not pay any cash dividends to stockholders except out of that part of its available surplus funds which is derived from realized net profits on its business. The net income for the Company at December 31, 2003 was (\$127,654).

**Note 5- Gross Paid in and Contributed Surplus**

**\$1,201,686**

The amount of the captioned asset is \$64,314 less than the \$1,266,000 reported in the Company's 2003 Annual Statement. Numerous loan payments (not only principal payments, but interest payments as well) were paid during 2002 and

2003 by the Company on commercial loans that were in the name of the Company's parent, Chappell Insurance Services.

The payments on the commercial loans to various banks for principal and interest during 2003 and 2002 totalled to \$64,314. ALA. CODE §27-37-2 states that "the following expressly shall not be allowed as assets in any determination of the financial condition of an insurer...advances to officers, directors and controlling stockholders, other than policy loans, unless the same are secured by collateral satisfactory to the commissioner, and advances to employees, agents, and other persons on personal security only."

The amount of \$64,314 is advances to its controlling stockholder and will be non-admitted from the Company's assets in its 2003 Annual Statement.

Surplus contributions received during the period under examination amounted to \$250,000. This infusion of surplus took place in 2002.

**Note 6 - Unassigned Funds (deficit)**

**(\$540,506)**

The captioned amount is the same as is reported in the Company's 2003 Annual Statement.

**CONTINGENT LIABILITIES AND PENDING LITIGATION**

Examination of these items included the following: a review of the Company's statutory financial statements disclosures; performance of a search for unrecorded items; obtaining letters of representation from management and Company's legal counsel; and, a review of the external auditors summary of pending litigation.

The Company did not report any contingent liabilities or pending litigation that were deemed to have potential for material adverse action on its surplus. The Company's President and Chief Financial Officer executed a letter of representation attesting to the non-existence of contested claims, unreported liabilities, and contingencies, as of December 31, 2003, and for the period from January 1, 2001 to December 31, 2003.

The examination found that the Company could be liable for fines, by the Alabama Department of Insurance, as a result of violations of several Alabama insurance statutes. The violations relate to: moving and maintaining claim records in Ohio and application and policy files in Georgia without the prior written consent of the Alabama Department of Insurance. Details of these violations are discussed in "Accounts and Records," page 15.

During the examination it was found that the Company was paying a car allowance to officers of the Company. There was no W-2 or Form 1099 provided that indicated that these car allowances were reported to the Internal Revenue Service. The Supplemental Compensation Exhibit provided by the Company agreed with the Company's payroll register and there was no indication that additional income was provided to either of the officers for car allowances. These advances for car allowances are deemed to be dividends. Details of this are discussed in "Dividends to Stockholder," page 13 and 23.

The certainty of any fines, and amounts thereof, can not be determined as of the date of this report. However, fines in the maximum amounts permitted by the pertinent statutes would definitely be material in amount.

### **COMMENTS AND RECOMMENDATIONS**

#### **Board of Directors – Page 7**

**It is recommended** that the Company's Board of Directors, or its designated committee, approve all investments made by the Company in accordance with ALA. CODE §27-41-5 (1975).

#### **Management and Control – Page 7**

According to Section 1 of the Company's Bylaws, "The annual meeting shall be held for the purpose of electing directors... Directors thereof shall continue to hold office until their successors are elected and qualified." The Company provided no evidence that the Directors were re-elected annually. Thus, the Company was not in compliance with its Bylaws with regard to holding an annual shareholders' meeting with the purpose of electing Directors for the period of examination. The Company should take appropriate actions to comply with its Bylaws with regard to the annual election of Directors.

**It is recommended** that the Company take appropriate actions to ensure compliance with its Bylaws with regard to the annual election of Directors.

According to Article III, Section 2 of the Company's Bylaws, "the officers of the Corporation are to be appointed annually at the regular meeting of the Directors held pursuant to Article II section 3 of the By-Laws." Only one complete election of the Company's officers was noted during the period under examination. The Company should take steps to ensure compliance with its Bylaws with regard to the annual election of officers.

**It is recommended** that the Company take appropriate actions to ensure compliance with its Bylaws with regard to the annual election of Officers.

### **Conflict of interest- Page 8**

The Company provided conflict of interest statements for its officers and directors, but conflict of interest statements were not completed for those people who have access to the Company's assets.

**It is recommended** that the Company review its conflict of interest policy to determine if it is comprehensive enough to meet the needs of the Company.

During the examination it was noted that a payroll advance was made to one of the Company's officers and the Company was making payments on loans belonging to officers/shareholders of the Company which are pecuniary interest violations.

**It is recommended** that the Company not loan money or make payments for its officers in accordance with ALA. CODE §27-27-26 (1975) and ALA. CODE §27-41-36(a) (1975)

### **Management and Service Agreements – Page 9**

**It is recommended** that the Company report all management and service agreements on *Schedule Y-Part 2* of the Annual Statement in accordance with the NAIC Annual Statement Instructions.

The Company has a Claims Administrator agreement with Cange and Woods, the Company's third-party administrator. This agreement has not been approved by the Alabama Department of Insurance.

The Company also has an Administrative Office lease agreement with its parent, Chappell Insurance Service, Inc. (the tenants) and 24 Drayton Street, LLC (the landlord). This agreement has not been approved by the Alabama Department of Insurance.

**It is recommended** that the Company obtain the approval for this lease agreement from the Alabama Department of Insurance in accordance with ALA. CODE §27-29-5 (b) (4) (1975).

**It is recommended** that the Company modify its existing Cost-Sharing Agreement so that it includes all of the involved affiliates and submit this Cost Sharing Agreement to the Alabama Department of Insurance for the Commissioner's approval in accordance with ALA. CODE §27-29-5 (b) (4) (1975).

**It is further recommended** that the Company identify every member of the holding company system in its registration statements in accordance with ALA. CODE §27-29-4 (1975).

### **Market Conduct – Page 12**

#### **Dividends to Stockholder**

During the examination it was found that the Company was making payments on bank loans that were in the names of officers/stockholders of the Company's parent. These payments are considered dividends.

**It is recommended** that the Company not pay dividends to its shareholder unless it has the prior approval of the Alabama Department of Insurance in accordance with ALA CODE §27-29-5(1975).

### **Accounts and Records- Page 16**

The Company utilizes a third-party administrator, Cange and Woods, LLC., located in Cincinnati, Ohio, to administer their claims. The fact that the claim files are removed and maintained outside of Alabama is not in accordance with ALA. CODE §27-27-29 (c) (1975) which states that it is a violation to remove these records from the state of Alabama without the prior written permission of the Commissioner of the Alabama Department of Insurance.

**It is recommended** that the Company comply with ALA. CODE §27-27-29 (c) (1975) by maintaining all its records within Alabama or by obtaining the approval of the Alabama Department of Insurance to continue its current practice. The issue of out-of-state record retention was previously addressed in a letter from the Insurance Commissioner to the President of the Company on August 15, 2003.

During the examination it was noted that the Company's application and policy files are maintained in Savannah, Georgia. This is also a violation of ALA. CODE §27-27-29 (c) (1975) which states that it is a violation to remove these records from the state of Alabama without the prior written permission of the Commissioner of the Alabama Department of Insurance.

**It is recommended** that the Company comply with ALA. CODE §27-27-29 (c) (1975) by maintaining all its records within Alabama or by obtaining the approval of the Alabama Department of Insurance to continue its current practice. The issue of out-of-state record retention was previously addressed in a letter from the Insurance Commissioner to the President of the Company on August 15, 2003.

## **Bonds- Page 21**

**It is recommended** that the Company only utilize custodial agreements that have been duly approved by the Commissioner of the Alabama Department of Insurance in accordance with ALA. ADMIN. CODE 482-1-077.04 (02) (0) (2003).

During the examination the Company could not provide the brokers' advices for the purchase and disposition of its securities.

**It is recommended** that the Company maintain accurate records of the transactions relating to bonds in accordance with ALA. CODE §27-27-29(a)(1975) which states that every domestic insurer shall keep complete records of its assets, transactions, and affairs in accordance with such methods and systems as are customary or suitable.

## **Cash and short-term investments – Page 21**

**It is recommended** that the Company's repurchase agreements comply with the NAIC Accounting Practices and Procedures Manual- SSAP 45, Paragraph 8 regarding proper collateral.

**It is recommended** that the Company comply with the NAIC Annual Statement Instructions regarding the required disclosure in its Notes to Financial Statements for its repurchase agreement.

**It is recommended** that the Company classify, in future financial statements, the amount paid for the securities via its repurchase agreement as short-term investments in accordance with the NAIC Accounting Practices and Procedures Manual- SSAP 45.

**It is recommended** that the Company classify, in future financial statements, the amount paid for the securities via its Expedition Money Market Fund and the STI Classic Money Market Fund as short-term investments in accordance with the Purposes and Procedures Manual of the NAIC Securities Valuation Offices.

**It is recommended** that in Schedule E-Part 1, the Company report separately all deposits in excess of \$100,000 or less than (\$100,000) in accordance with the NAIC Annual Statement Instructions.

During the review of cash items, several vouchers could not be produced for funds transfers and for checks written.



**It is recommended** that the Company maintain accurate records of its business affairs and retain supporting vouchers for the issuance of checks in excess of \$25.00 in accordance with ALA. CODE §27-27-30 (1975).

**Dividends Paid –Page 23**

**It is recommended** that the Company not pay dividends without the prior approval of the Alabama Department of Insurance in accordance with ALA. CODE §27-27-37(a)(1975).

**Gross paid in and contributed surplus- Page 23**

**It is recommended** that the Company not pay advances to its parent and sole stockholder in accordance with ALA. CODE §27-27-2 (2) (1975).

**SUBSEQUENT EVENTS**

During the examination it was determined that the Company's investments as of December 31, 2004 exceeded the investment limitation.

The amount in excess was \$105,086.

ALA. CODE § 27-41-6 (a) (1975) states:

“(a) An insurer shall not have at any one time any single investment or combination of investments in...or securities of any one person aggregating in cost to the insurer in excess of the greater of 10 percent of such insurer's assets or the total of its capital and surplus, as shown in the latest annual report of the insurer..., less the minimum and capital and surplus required of said insurer.”

The calculation of the December 31, 2004 investment limitation is as follows:

1,225,494	12/31/03 surplus
<u>(500,000)</u>	27-3-7 = \$400M capital & Reg. 63 \$100M surplus
725,494	27-41-6(a) Investment Limitation
930,580	Compass Bank
<u>(100,000)</u>	FDIC
<u>(725,494)</u>	Investment limitation
105,086	Excess to be non-admitted as of 12/31/2004

The Company must non-admit \$105,086 from its admitted assets in its 2003 Annual Statement.

During the subsequent review of cash items, it was noted that in 2004, the Company continued its practice of paying bank notes that were in the names of its President and one of its Vice Presidents. A total of \$9,516 was paid on these bank loans in 2004. The Company purported that by paying these bank notes, they were actually providing a car allowance for these officers. The Company could not provide evidence that these car allowances were listed as additional income to the Internal Revenue Service. ALA. CODE § 27-27-29(a)(1975) states that every domestic insurer shall keep complete records of its assets, transactions and affairs in accordance with such methods and systems as are customary or suitable. The Company did not report the income for these officers properly.

Further, the President and Vice President are stockholders of the Company. The payment of the car allowances is a dividend as defined in ALA. § CODE 27-27-37 (a)(1975) which states "A domestic stock insurer shall not pay any cash dividends to stockholders except out of that part of its available surplus funds which is derived from realized net profits on its business." The payment of these bank notes by the Company for these stockholders is also a pecuniary interest violation as set forth in ALA. Code §27-27-26 (1975). The amount of \$9,516 is immaterial and no adjustment will be made to the 2004 Annual Statement.

**It is recommended** that the Company not pay car allowances (dividends) to its officers in accordance with ALA. CODE §27-27-37 (a) (1975) and ALA. CODE §27-27-26 (1975).

On April 22, 2005 an Order to Show Cause was issued to the Company by the Alabama Department of Insurance as it was found that the Company met the standards for the determination of hazardous financial condition as set forth in Departmental Regulation No.101, Section 3(2):

Departmental Regulation No. 101, Section 3(2) states as follows:

Section 3. Standards. The following standards, either singly or a combination of two or more, may be considered by the Commissioner to determine whether the continued operation of any insurer transacting an insurance business in this state might be deemed to be hazardous to the policyholders, creditors or the general public. The Commissioner may consider:

. . . 2. The National Association of Insurance Commissioners Insurance Regulatory Information system and its related Reports;

The Insurance Regulatory Information System is a statistical tool that calculates A number of different ratios utilizing the financial data contained in the Company's December 31, 2004 financial statement. The ratio results are then compared to a "usual range" of results established from studies of the ratios for companies that have become insolvent or have experiences financial difficulties in recent years. The Company's results for the following ratios fell outside the "usual range":

1. Gross Premiums Written to Policyholder Surplus
2. Surplus Aid to Policyholder Surplus
3. Two Year Overall Operating Ratio
4. Investment Yield
5. Change in Policyholder Surplus
6. Liabilities to Liquid Assets

## **CONCLUSION**

Acknowledgement is hereby made of the courteous cooperation extended by persons representing Quality Casualty Insurance Company during the course of this examination.

The customary insurance examination procedures, as recommended by the National Association of Insurance Commissioners, have been followed in connection with the verification and valuation of assets and the determination of liabilities set forth in this report, to the extent possible utilizing Company records and accounts.

In addition to the undersigned, R. Glenn Taylor, ACAS, MAAA, and Randall D. Ross, Associate, Consulting Actuarial Examiners, all representing the Alabama Department of Insurance, participated in this examination of Quality Casualty Insurance Company.

Respectfully submitted,

A handwritten signature in cursive script, reading "Thomas W. Salo", written over a horizontal line.

Thomas W. Salo  
Examiner-in-Charge  
State of Alabama  
Department of Insurance

May 16, 2005